Analysis

Changes to treatment of offshore developers and dealers in UK land

Speed read

In Budget 2016, HMRC announced the introduction of rules intended to ensure that profits from a trade which involves either dealing in or developing UK land are always chargeable to UK corporation tax or income tax. For HMRC to achieve this, such overseas traders must be unable to claim relief under a double tax treaty. At the same time as announcing the changes to the domestic legislation, the UK's treaties with Jersey, Guernsey and the Isle of Man have been amended to ensure that the UK has the relevant taxing rights over its own land. The details of the legislation are awaited at report stage of Finance Bill 2016. Specific anti-avoidance rules will be introduced to prevent the new charge being avoided in the interim, including steps to capture historic increases in value. The latest changes place severe pressure onto structures which seek to shield trading profits from dealing in and developing UK land through double tax treaties.

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For many years, some taxpayers have sought to shield profits from trading and developing UK land. Their approach is to have the relevant activities carried out by a vehicle in an overseas jurisdiction which enjoys the benefit of relief under a double tax treaty with the UK. Legislation, including what is now TIOPA 2010 s 130, was introduced in FA 2008 to prevent UK resident persons taking advantage of this kind of arrangement.

Where the ultimate economic ownership of the trading vehicle is overseas, there is logic in choosing to use a company situated in an appropriate treaty jurisdiction, thereby shielding the profits from UK tax. Classically, the taxpayer then relies upon the business profits article of the relevant treaty. Relief is claimed on the basis that although the profits have a UK source, the trader does not have a UK permanent establishment because it has neither a fixed place of business in the UK, nor any agent other than one of independent status.

HMRC's view

Although no case has yet reached trial, HMRC is understood to have a longstanding dislike of this kind of arrangement. The technical note, published on Budget day (see www.bit.ly/1pMfZTH), repeats HMRC's long-held view that it is very difficult for an overseas company to avoid creating a UK permanent establishment where it has engaged contractors to carry on construction activities at a UK building site. The counterargument for taxpayers is that the building site is the stock of the landowner and only a permanent establishment of the contractor. Nevertheless, HMRC is challenging structures on this basis, the technical note states.

HMRC also has the ability to attack these arrangements using diverted profits tax (DPT). HMRC's argument is essentially that DPT applies because the developer uses a structure which avoids creating a UK permanent establishment. Importantly, the exception for agents of independent status only applies in relation to DPT if the agent is unconnected with the trader. However, there are counterarguments available to taxpayers in respect of DPT, including about how much of the profit in the UK will be caught.

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The full technical analysis of these arrangements is complex and outside the scope of this article. Indeed, from HMRC's perspective, the clear aim of the new rules is to enable these arrangements to be defeated without difficult legal battles and complex fact-finding exercises. However, two additional existing areas of pressure should be noted.

First, the correct implementation of this kind of arrangement is not only essential but also time consuming. If all of the relevant decisions are made by individuals in the UK, the arrangement will fail on the basis that the company which claims treaty relief is resident here. Second, as UK rates of corporation tax have continued to fall, so the incentive to adopt this kind of arrangement has reduced. Given that activities such as construction works and marketing which are carried out in the UK would need to suffer UK tax, then as a percentage of profit the relevant saving has become increasingly small.

The proposed new rules: what can we expect?

As a result, this kind of arrangement has become much less popular. Nevertheless, the objective of the new rules is clearly to ensure that it is no longer advantageous. The technical note explains (at para 10) that:

'The key change will be to remove the current territorial restriction in UK legislation so that the profits of a trade carried on by a company are subject to corporation tax on income where the trade comprises dealing in [or developing] UK land … regardless of the residence of the company.'

Equivalent changes will be made for income tax. We are told that the new legislation will provide that non-resident companies will be taxed on trading profits from UK property, regardless of whether there is a UK permanent establishment.

However, whilst this seems clear, it is not actually much of a change as a matter of purely domestic law. A non-resident company trading in UK land, if outside the scope of corporation tax, was already chargeable to UK income tax on its profits. The crucial point was that this income tax charge is potentially relievable under a double tax treaty. Treaties are, of course, sovereign agreements and so override UK domestic legislation. Accordingly, for the new rules to have the effect which HMRC desires, they must not be defeated by any treaty protection.

This critical point is not lost on HMRC. As stated above, the Guernsey, Jersey and Manx treaties have been amended so that the UK has the right to tax income derived from immovable property and gains from its alienation. The amendments follow the drafting of the OECD Model Treaty. There is an argument that income from immovable property does not include profits from its sale. In the commentary on the OECD Model Treaty, Canada expressly reserves the right to tax such profits. There is also a good argument that the gains article does not cover trading transactions, although HMRC can dispute that. It will be interesting to see what happens in relation to this.

It seems likely that the UK's domestic legislation will be amended to restrict a taxpayer's ability to rely on a treaty in a way which conflicts with the new rules. However, as treaties take precedence, taxpayers may still seek to invoke the treaty and argue that sales of land as stock remain protected. Although the technical note does not address this expressly, some sort of change to domestic law should be required to ensure that treaty protection does not apply. The author understands that HMRC is tending against an express override and will seek to rely on the gains article. However, some change to domestic law ought to be necessary to tax trading income as gains.

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This may be presented as a limited override, which puts the position beyond doubt where the treaty gives the UK taxing rights over income from land and gains. Moreover, the new agreements between the UK and, for example, Jersey, are clearly intended to catch traders in UK land. As a treaty is a contract between sovereigns and to be interpreted as such, this makes it very difficult for any taxpayer established in the relevant jurisdictions to argue that it is still protected.

The new charge is supplemented by two anti-avoidance provisions. One prevents 'fragmentation' arrangements, where functions associated with a development are undertaken by a second non-resident company which does not own land. If connected entities are used in this way, the profits will be aggregated and charged. Second, a rule based on the existing transactions in land provisions applies to prevent companies being established as investment vehicles with the shares then sold. This new rule will go wider than the old transactions in land provisions. Care will need to be taken where shares in a genuine investment company are sold, so as to ensure that the new charge does not apply even where there is no trading intent. The risk of collateral damage to investment structures is an important area of concern.

Operational and practical issues

The new charge applies to disposals that occur on or after the date the legislation is introduced in Parliament at report stage, likely during June 2016. However, the treaties are amended with effect from 16 March. This raises some interesting potential questions as to how the new rules operate.

If it is simply a matter of amending the treaty, why are new UK domestic rules even needed in the first place? On the other hand, if new UK domestic legislation is required, then on what basis does this override the treaty protection? Unlike with DPT, HMRC cannot argue that this is a new tax which is covered by the treaties. This again points towards treaty protection being expressly overridden.

A targeted anti-avoidance rule is to be introduced with retrospective effect from 16 March 2016. This prevents transfers of land to a related party that is not intended to be the ultimate recipient, as well as migrations to states with more favourable treaties. Taxpayers are therefore unable to capture the benefit of any uplift in value which has arisen until now. Unsurprisingly, the rule will contain a broad provision which will stop any arrangement the main purpose of which is to secure that profits are outside the scope of the new charge.

For anyone contemplating establishing an arrangement of this kind, it is clear that the new project faces a mountain of obstacles and a very limited incentive to overcome them. The much more straightforward course is to use a UK company, or at least a company within the scope of UK corporation tax. Profits might then perhaps be shielded by obtaining a deduction for finance costs. However, this kind of strategy is also under pressure, as HMRC is looking, as announced in Budget 2016, to cap the amount of interest relief to 30% of taxable earnings in the UK or for it to be based on the net interest earnings ratio for the worldwide group.

What is clear is that the wind is blowing against these kind of structures

The decision in *Ardmore Construction v HMRC* [2015] UKUT 0633 (TCC) is also unhelpful to taxpayers seeking to structure loans so as not to have a UK situs; the exemption from withholding tax for quoted Eurobonds merits consideration.

Those with existing structures face interesting questions as to what to do but probably very limited options. No doubt the anti-avoidance rule will be widely worded, so the straightforward course is simply to pay the tax. Consider also the argument that reserving taxing rights under the immovable property article does not give the UK the ability to charge tax in respect of sales of land, though the details of the legislation will need to be reviewed.

There are also potential quirks which the legislation may yet address, such as the position in relation to income tax losses where a company is brought within the charge to corporation tax. Finally, although land cannot have an indeterminate status, we may see disputes as to whether or not existing sites are held as stock or as an investment.

What is clear is that the wind is blowing against these kind of structures. The longer term status of non-residents investing in commercial real estate is also increasingly doubtful. The new changes also form part of an increasing trend towards transparency for real estate structures. ■

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- *Ardmore* and UK source income (Peter Vaines, 13.1.16)